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Why Portfolio Construction Matters (First of a Series)

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What makes for successful portfolio construction in private credit? That was one of the questions panelists addressed at the Private Credit Investor Summit last week.

The issue carries more urgency amid current public market turmoil. Equities tumbled this week after a worse-than-expected May CPI report. Besides the number itself (8.6%), highest in four decades, the breadth of inflation has made it clear lofty prices are here to stay for a while.

Leveraged loans will always be thrown into some kind of non-investment grade risk bucket. Middle market loans, being less leveraged and covenanted, are a more conservative play on the theme, but recessions will always test borrowers no matter how creditworthy.

How do private credit managers think about what goes into their portfolios? We've observed not every manager puts credit quality in the forefront. Not to say they look for bad deals. But if raising money and putting it to work quickly is the priority, then sourcing takes precedence. In effect, risk management means opening a wider investment funnel.

And why not? Over the past twelve years economic conditions were benign, rates and defaults low, and markets liquid. If you put a lot of capital to work quickly, by the time there was a portfolio problem (or two), your AUM had enough critical mass to absorb it.

One problem with this approach is timing. You never know what's round the corner. Covid-19 caught some managers early in scaling their assets. They were lucky the downturn was so short-lived; that the Fed stepped in as rapidly with liquidity as they did.

The other problem: To offset increased defaults and losses and still meet your return hurdles, you have to chase higher yielding assets. That elevates you into a higher risk gear with no easy way to back down. On the other hand, if you always distinguish between top and second-tier opportunities, it leaves you better prepared for a downturn.

Private credit managers are often lumped together in a class, but their strategies often differ. Non-sponsored companies carry different risk profiles because they lack the backing of a deep-pocketed private equity owner. While generally lower leveraged, they can demand equity-like attention from lenders in a recession. Their portfolio management can be a complex exercise.

BSL managers, in contrast, rely on a liquid secondary market to manage portfolio risk. Trading acts to top up or trim back positions in certain sectors. But amid extreme volatility, bid/ask spreads gap out. Small scale selling creates pricing downdrafts. Liquidity is illusory.

Mid caps are borrower-specific and resistant to macro risk resetting. Investors instead rely on managers to underwrite underlying positions cautiously and industry concentrations accordingly.

Next week: We look at some key ingredients to successful portfolio construction.